McMillan Reservoir Sand Filtration Plant – Office Market Analysis

INTRODUCTION AND METHODOLOGY

Hammer, Siler, George Associates has been retained to conduct market analyses to determine the potential of the McMillan Reservoir site to support a variety of land uses. This memorandum presents the findings of our analysis into the market potential for office use including both general multi-tenant office space and neighborhood professional office space such as doctors offices, real estate offices and attorneys' offices.

In order to determine the quantity of floor space capable of being supported by the market, we have utilized the following methodology:

?? An analysis of the performance of the District office market including recent office absorption data.

?? Research into the potential for medical office space on the property associated one of the four major medical facilities near the property.

?? An assessment of the number and types of neighborhood professional office space that would typically accompany a community size retail center.

?? Generation of estimates for the quantity of both types of office space capable of being supported by the market.

OFFICE MARKET ANALYSIS

Introduction

We have utilized data from a variety of sources to determine the strength of the District office market and to identify past trends. This data is used to develop estimates for the total quantity of new office space that can be supported by the market and, is this is then subsequently used as an input in the development of HSGA's estimates of the market share that the McMillan property can capture. The data we have utilized includes the total quantity of space in the market, trends in the absorption of office space, the quantity of space under construction, vacancy rates and rental rates prepared by Delta Associates, Grubb and Ellis, Spaulding and Slye and Insignia/ESG. While there are variations in the data between these sources, it is possible to identify trends and gauge the overall health of the market. We have used our own knowledge of the local market to develop estimates that we feel most closely reflect the District office market performance.

Supply Analysis

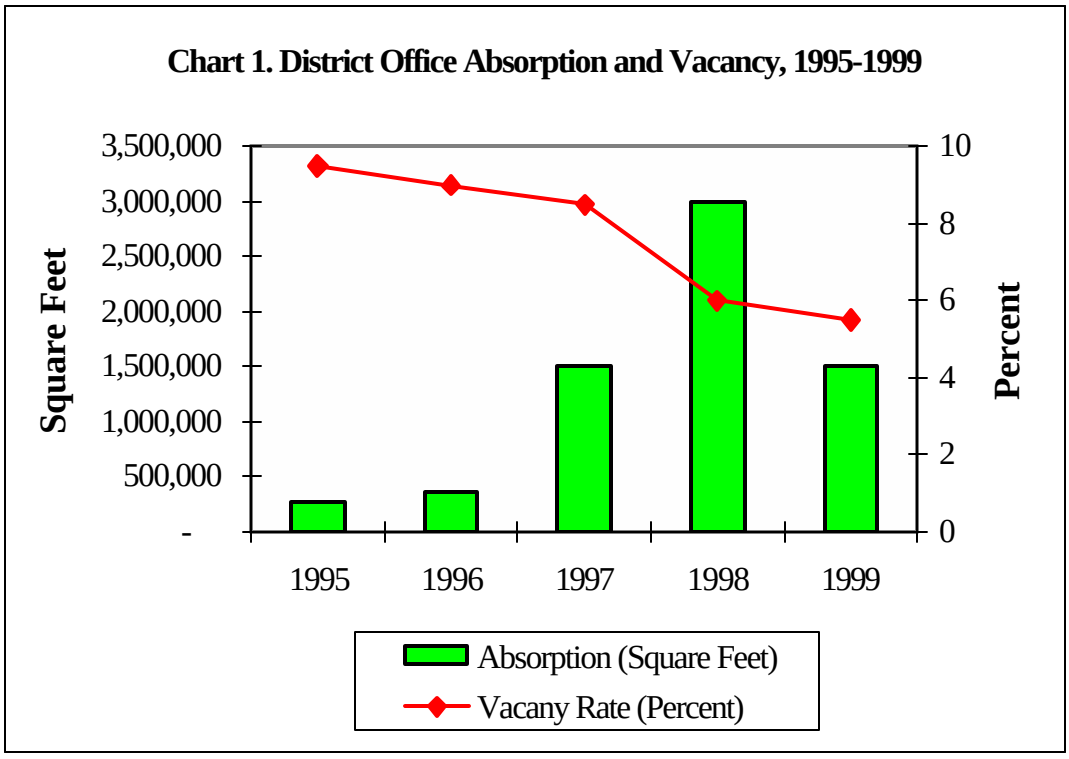
We estimate that there is currently approximately 95 million square feet of office space in the District of Columbia. We envision that the property would likely be developed as Class B Space, potentially with a Class A component. Of the total existing inventory, we estimate that approximately 80 percent is comprised of class A and B space or 76 million square feet. There is also approximately four million square feet of class A and B space currently under construction in the District of which approximately 60 percent is pre-leased.

Demand Analysis

In order to determine the strength of demand in the office market we have utilized a modified expressed demand approach. To determine the magnitude of the demand, we have examined

published vacancy rates for the District of Columbia and compared the results with a ten percent vacancy rate that is widely considered full or "stabilized" occupancy for bank lending purposes for office space. This differential between any vacancy rate lower than ten percent can be expressed as explicit demand and converted to the quantity of space that can be constructed while maintaining a tight office market. We have then examined rents and absorption rates to provide additional input into past and current market performance and likely future performance during the next several years.

Vacancy Rates. Chart 1 graphically illustrates the decline in the vacancy rate for all office classes in the District during the period between 1995 and 1999.



This vacancy rate has steadily declined during the past 5 years from approximately 9.5 percent in 1995 to approximately 5.5 percent at the end of 1999. We estimate that the vacancy rate of class A and B office space is currently approximately 3.75 percent. This vacancy rate is well below that generally considered as the stabilized or demand-supply equilibrium vacancy rate of 10 percent.

Absorption. Chart 1 also illustrates office space absorption in the District for all classes between 1995 and 1999. The Chart illustrates that absorption increased dramatically between 1995 and 1998 and then slowed during 1999. We estimate that approximately 1.6 million square feet of office floor space was absorbed in the District in 1999 compared to approximately 3 million square feet absorbed during 1998. The recent slow down is reflective of the drop in new construction as large vacant sites have become more scarce.

Rents. Office rental rates in the District and increases during the past several years are indicative of a very strong office market. Average rents have increased by around 9 percent per annum during the past two years, well above the rate of inflation at approximately 2.5 percent. Rents are now as much as $50 per square foot in some Class A buildings with the average rent for all space at around $30.

Unmet Demand. We estimate that at the present time there is an unmet demand for approximately 2 million square feet of class A and B floor space in the District. The absorption and rental rate analysis suggests that the market will be capable of absorbing this floor space during the next two years.

Market Capture and McMillan Site Potential

Based on the excellent accessibility of the McMillan property and its proximity to downtown, we anticipate that it should be able to capture approximately three percent of total unmet demand in the District. This translates to 60,000 square feet of office development on the subject property.

MEDICAL OFFICE MARKET

We have contacted personnel at the various medical institutions in proximity to the subject site in order to assess the potential for a medical office development component on the McMillan property. The response to our inquiries suggests that at present there is no such potential but

that the Washington Hospital may consider expanding the 225,000 square feet of medical offices in two buildings it has at present, perhaps three years to five years from now. We do not recommend this as a development component at the present time.

NEIGHBORHOOD PROFESSIONAL OFFICE MARKET ANALYSIS

There are several methods of determining the quantity of neighborhood professional office space that is capable of being supported by the market. One method is to utilize published standards for the number of professionals of various types per 1,000 resident population. The market potential is determined by estimating the floor space currently in the trade area in each professional category, dividing this floor space by the number of residents in thousands and comparing the actual floor space ratios to the standards. Any shortfall in the actual ratio can be easily converted to a market potential in square feet. However, such standards are no longer available and in the absence of substantial empirical and field research, another approach needs to be followed.

An alternative yet equally valid approach to the ratio analysis, is to conduct an analysis of the mix of neighborhood professional office uses found in actual community retail centers of the type envisioned for the subject site. In following this approach, we have assigned square footage requirements to each professional category based on the actual median sizes found in community retail centers. Table 1 below presents the findings of the analysis.

TABLE 1. NEIGHBORHOOD PROFESSIONAL OFFICE USES AND MEDIAN SPACE NEEDS

Use	Median Size (Square Feet)
Banks and Savings and Loan	2,800
Real Estate	1,400
Insurance	1,000
Legal	1,400
Medical and Dental	1,300

Optometry	1,500
Other	800
Total	**10,200**

Source: Dollars and Cents of Shopping Centers, 1995 and Hammer, Siler, George Associates

Our field research did not reveal any unusually high concentrations of these uses in the area surrounding the subject site and no other factors suggest that these uses could not be incorporated into the development on the subject site. As such, the total neighborhood professional office market identified for the McMillan property is approximately 10,000 square feet.